

General Information Letter: Illinois uses the federal income tax definition of "employee" for withholding purposes.

September 8, 2005

Dear:

This is in response to your letter (undated), which was received by this office on June 13, 2005, in which you request advice. Department of Revenue ("Department") regulations require that the Department issue only two types of letter rulings, Private Letter Rulings ("PLRs") and General Information Letters ("GILs"). PLRs are issued by the Department in response to specific taxpayer inquiries concerning the application of a tax statute or rule to a particular fact situation. A PLR is binding on the Department, but only as to the taxpayer who is the subject of the request for ruling and only to the extent the facts recited in the PLR are correct and complete. GILs do not constitute statements of agency policy that apply, interpret or prescribe the tax laws and are not binding on the Department. For your general information, the regulation governing the issuance of letter rulings, 2 Ill. Adm. Code Part 1200 regarding rulings and other information issued by the Department, can be accessed at the Department's website. That address is www.revenue.state.il.us/legalinformation/regs/part1200.

The nature of your question and the information provided require that we respond only with a GIL.

In your letter you state in part as follows:

I've been told that if a person works for a family business that only hires people for dead-lines and pays cash, not check, that that person is not an employee and that the cash they are paid is not wages.

I'm thinking that the person is an employee and the wages or money paid is wages and is to be claimed on your tax returns.

An individual who receives income in exchange for rendering personal services is either an "employee" or an "independent contractor." "Wage" income, i.e., compensation paid to an "employee" in exchange for services, is not the only type of income that must be reported on a tax return. In other words, income may be reportable and taxable even though it is not "wages" paid to an "employee." One example of this is rental income. Another example is compensation paid for services rendered by an individual working as an independent contractor. The technical term for this latter type of income is "business income" rather than "wages."

Please be advised that for Illinois Income Tax Act (IITA) purposes, the term "employee" is defined at 86 Ill. Adm. Code 100.3100 b). That regulation states as follows:

Employee

Compensation is defined as remuneration for personal services performed by an 'employee'. If the employer-employee relationship does not exist, remuneration or services performed does not constitute 'compensation'. The term 'employee' includes every individual performing services if the relationship between him and the person for whom he performs such services is the legal relationship of employer

and employee. *The term has the same meaning under the Illinois Income Tax Act as under ... (Internal Revenue Code)... 26 U.S.C. Section 3401(c) and 26 CFR 31.3401(c)-1.* (emphasis added).

As you can see from the regulation, the Department looks to whether the employer-employee relationship exists for federal income tax purposes in a given set of circumstances to determine whether or not a taxpayer is an "employee." Without more information on the nature of the services performed and the contractual relationship between the business and the individual, we cannot offer definitive guidance for determining whether or not the individual is an employee.

For IITA purposes, there are two main reasons for classifying a person as either an "employee" or an "independent contractor." First, an "employee" must generally have federal and state income taxes withheld from his or her "wages" throughout the taxable year every time a paycheck is issued. By contrast, "business income" paid to an independent contractor is not subject to income tax withholding. Instead, the independent contractor may have personal responsibility for making federal and state estimated tax payments on a quarterly basis based upon his or her anticipated income tax liability for the entire year.

Second, many individuals live in one state and earn income from another, or from both. In cases where a taxpayer may have income tax obligations with more than one state, rules are needed to determine how much and what kind of income each state may tax. Like many states, Illinois has enacted such rules, and they assign income between states based upon whether the individual is a resident or not, and whether the income is "wage" income or "business income." Generally, all income earned by an Illinois resident is taxable in Illinois. Such income may also be taxable in another state (e.g., the state in which "wage" income is earned, like where a resident of Alton, Illinois drives across the state line to work as an "employee" for a Missouri "employer.") As an aside, Illinois allows resident taxpayers a credit for taxes paid to another state on the same income.

A person's Illinois tax calculation starts at Line 1 with his or her federal adjusted gross income (FAGI). The amount reported as FAGI is allocated between Illinois and other states, if applicable on Schedule NR. To this figure, certain items peculiar to Illinois are added and subtracted. The sum of the Illinois-allocable amounts is transferred to and reported on Line 14 of the IL-1040. This remaining amount, less an individual's allowable personal exemptions, is that person's Illinois taxable income.

Applying all this to your questions, we assume the individual in question is an Illinois resident, since you do not indicate to the contrary. In that case, all of his or her income included in FAGI will be allocated to Illinois for income tax purposes, whether or not the person is an employee.

Whether or not the income in question is "wage" income paid to an "employee" will be determined based upon federal law. If it is considered to be wage income federally, it will be so classified for IITA purposes. According to our research, the purpose for hiring a family member (usually a child of the business owner) as an employee of a "family business", is to shift income from an adult or business which pays income tax at a higher rate to a child, who pays taxes at a lower rate on income in excess of personal exemptions. In the typical "family business" scenario, the compensation paid to the family member is considered to be wages (see below).

You should be advised that many businesses wrongfully claim that the people who work for them are "independent contractors" rather than "employees" in order to avoid the time and expense of withholding and Unemployment Insurance, as well as to avoid making matching payments regarding Social Security. There is no mechanism in the IITA to force such businesses to do otherwise. Thus, an individual receiving any payments from such a business may be subject to Illinois income taxes on such income. Furthermore, the individual might be under an obligation to make estimated tax payments on such income or face underpayment penalties when the return for the year is due. Doing so however, would defeat one of the purposes of the "family business" setup, which is to allow the "family business" to claim a deduction for wages paid to the family member/employee.

We apologize for the delay in issuing our reply, and hope the above adequately responds to your inquiries.

As stated above, this is a GIL which does not constitute a statement of policy that applies, interprets or prescribes the tax laws, and it is not binding on the Department. If you wish to obtain a PLR which will bind the Department with respect to the application of the law to specific facts, please submit a request conforming to the requirements of 2 Ill. Adm. Code Part 1200.

Sincerely yours,

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